

Can Wealthy Nations Afford Income Security for their Ageing Population ?

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My first, more spontaneous answer to question in the title is a counter-question: Why not ? If a country is wealthy why should it not be able to provide income security to everyone, including the old, the young, the working and the non-working population? By income security for the elderly I understand an income level which enables the pensioners to maintain their levels of living standard which they have reached in the last years of their working lives, and, if this level is miserably low, raise it to above the poverty line. In non-monetary terms this requires the transfer of a certain share of goods and services produced and provided by the working population of a certain year to the retired generation of the same year (regardless of the way in which such transfer is organised). If a country is wealthy, it should be able to afford such a transfer – provided there is a consensus that this is desirable.

My second answer, after a some consideration, is: It depends. It depends on a fairly large number of factors: How wealthy is the nation, how many retired people are there, how long is their life expectancy after retirement, how many other people (children, unemployed, housewives) are there who need to be taken care of by the working population. How large and how productive is the working population etc.etc.

But then again I arrive at a third answer which is a firm: yes, but...Income security will not come automatically but requires determination and deliberate and efficient policies which keep the level of economic activity and wealth creation continuously growing and distributes the results of this activity in a fair way. The level of goods and services which constitute the material wealth of a society depends on the amount of the hours worked in this society and on the productivity of this work. On this basis a political or societal decision has to be made about distribution, that is in our case about how much of this wealth should be given to the elderly after they have terminated their working life.

At this point the current debate about the “pension crisis” comes in: The root of this crisis is seen in the demographic changes, that is the fact that due to higher average life expectancy and lower birth rates the number of older people increases absolutely and relatively to the number of younger people. Although this has been the case since at least 150 years and started well before the introduction of formal social security systems the process is said to reach a critical stage during the next three or four decades. The OECD has already in the late 1980s warned against the social implications of an ageing society. In 1994 the World Bank published its famous report “Averting the Old Age crisis” in which it proposed a thorough reform of public PAY-AS-YOU-GO pension systems (PAYG) by replacing it through the three-pillar-systems. This report has been the blueprint for the changes of pension schemes towards completely or partly privatised and capital funded systems.

The core of the debate is the assertion that the burden for the active working population which has to work for their own and the pensioners living is under the current social security system rising in a way which is neither fair nor viable in the long run. For Germany for instance, where the demographic change will be most accentuated amongst all European countries it is for instance said that while today about four workers have to work for one pensioner, it will be only two in 2050, the burden will therefore be doubled. From this diagnosis it is concluded that to avoid a breakdown the whole system of social security must be thoroughly reformed. The direction of the reform has to go towards a shift from a public PAYG system to a private capital funded scheme, in which the future pensioners must contribute more to their future living standard and not leave the whole work to the younger generation.

In the following I will deal with this problem in six propositions and try to demonstrate that *first*, maintaining the living standard of a relatively larger retired generation requires with necessity the transfer of a higher share of goods and services produced and therefore of national income in one year to the pensioner generation of the same year, *second*, this is possible without a loss in living standard for the working population if the economy and employment are growing sufficiently, *third*, to keep up socially sustainable growth requires determined political intervention in and control of the economy, *fourth*, privatising the pension systems would not only not stabilise but considerably destabilise social security and put pensioners living standards at a risk,

fifth, if in spite of this privatisation of social security is pursued it is not for the benefit of the pensioners but for the benefit of financial institutions and a matter of redistribution from the bottom to the top, and

sixth, pension reforms should concentrate on the broadening of the revenue basis and number of recipients within the framework of a public PAYG system.

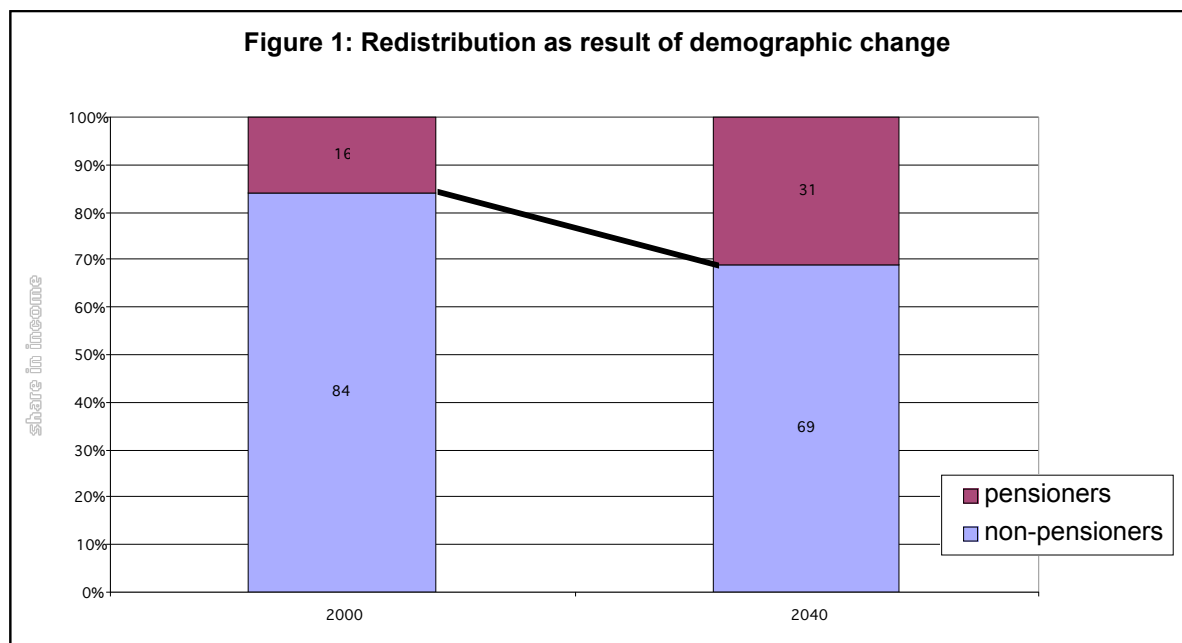
First proposition:

If the share of pensioners in the total population rises income security requires the transfer of a larger proportion of the current national income to the pensioners i.e. a redistribution in favour of the elder generation.

Current national income represents the bundle of goods and services which are produced or provided in the current year and which are the basis of every private and social consumption. All these goods and services are produced by the working (or active) population in a current year. Part of their product is transferred to the non-active population, which includes more than just pensioners: namely children below the age of 15, and all people between 15 and 65 years who are not employed, be it as formally unemployed, sick persons, housewives etc. Strictly speaking it is this non-active population which has to be supported by the active population every year, not only the pensioners. But here we refer only to the pensioners and ask what happens if as a result of higher life expectancy and lower birth rates the share of elder than 65 years people in total population rises. If we further assume that the average living standard of elder people corresponds to the average living standard of the working population of the same period, such an increase in the share of pensioner population requires the transfer of a higher share of the products and services generated by the active population to the pensioners. There is no way of getting around this basic requirement.

This is the fact which is at the bottom of the public discussion about the financial crisis of the current pension system and about intergenerational fairness and equity. If the share of the non-active population rises, the active population has to bear an increasing burden, or better to accept an increasing reduction of the proportion of their product which remains with them as basis of their living standard. If the share of pensioners rises between 2000 and 2040 from 16 to 31%, which is roughly the forecast for Germany, then the share of goods and services produced which remain for the non-pensioners falls from 84% to 69%. (see figure 1) This comes

from the fundamental fact that the pensioners have always been and must always be alimented by the active population of the same period. The burden for the working population in terms of losses of shares in total income rises.



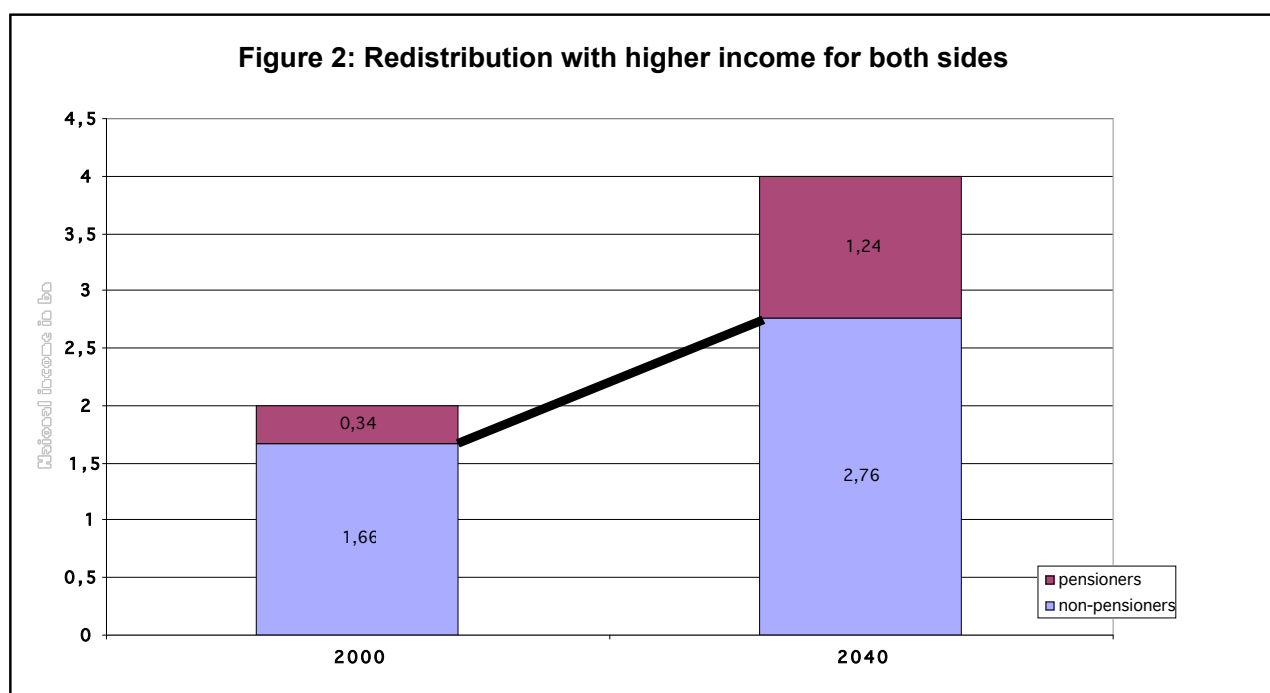
The first decision therefore, which must be made under circumstances of an ageing population is whether this redistribution of the yearly product in favour of the pensioners is accepted. This is no economic decision but a deeply political decision about the social model, the role of social cohesion and social solidarity of a society.

Although this decision is not an economic one it can be facilitated by considerations about the economic consequences, particularly how losses of shares of GDP for the active population to maintain the living standard of the pensioners affect the living standard of the non-pensioners.

Second proposition:

The redistribution of goods and services in favour of the pensioners is compatible with stable and rising living standards for non-pensioners, if the GDP grows faster than the share of the pensioner population.

If for instance, to remain at the German case, real GDP, that is the volume of goods and services doubles between 2000 and 2040 from € 2 trillions to € 4 trillions – which requires a yearly rate of growth of 1,7% - the lower share of income remaining with the working population (69% instead of 84%) would still represent a volume of goods and services in 2040 which is two thirds higher than 2000: If income increases from € 2 trn to € 4 trn the smaller share (69% instead of 83%) going to the active population would increase from € 1,66 trn (= 84% of 2 trn.) to € 2,76 trn (= 69% of 4 trn.) that is by 1,1 trn. or 66% (see figure 2)



This example can be generalised: The capability of a society to maintain the income and living standard of an ageing population without losses for the working population depends in the first place on the development of the economy. If economic growth is sufficiently high then the support of a higher proportion of elder population is no problem. If not, it is a problem.

To clarify the point further let us look at different growth rates of real GDP (from 1,0% to 2,5% per year) and different time periods (from 30 to 50 years). Table 1 shows to which amount an income of 1000 at the beginning of the period has risen at the end of the period assuming different rates of yearly growth.

Table 1: Development of an initial total income of 1000

Time horizon in years Yearly GDP increase	30	35	40	45	50
1,0	1348	1417	1489	1565	1645
1,5	1563	1684	1814	1954	2105
2,0	1,848	2000	2208	2438	2692
2,5	2098	2373	2685	3038	3437

Even the most modest assumption, a yearly increase in productivity of only one percent would after a relatively short period of 30 years (short because demographic changes are slow) lead to an increase in GDP of 35%. Less modest assumptions like 1,5% productivity increase over 40 years will result in a GDP increase of 81%.

Let us now assume that the share of income which goes to the pensioners, rises from 20% at the beginning to 30% at the end of the respective period, so that the share of income for the non-pensioner population falls from 80% to 70%. Table 2 shows the income which under the different constellations of GDP growth and time periods would accrue to the non-pensioners.

Table 2: Development of non-pensioners income after a demographic shift

Time horizon in years Yearly GDP increase	30	35	40	45	50
1,0	944	992	1042	1096	1152
1,5	1094	1179	1270	1368	1474
2,0	1294	1400	1546	1707	1884
2,5	1487	1661	1880	2127	2406

At the beginning of the time period the income of pensioners was 200 and non-pensioners 800 €. At the end of the period the non-pensioners income has risen depending on the rate of growth and the time period, the increase ranges from € 143 million to € 1606 million. Table 3 shows which relative increases this means for non-pensioners.

Table 3. Increase in non-pensioners income after a demographic shift in %

Time horizon in years Yearly GDP increase	30	35	40	45	50
1,0	17,9	24,0	30,3	37,0	44,0
1,5	36,8	47,4	58,8	71,0	84,3
2,0	61,8	75,0	93,3	113,4	135,5
2,5	85,9	107,6	135,0	165,9	200,8

In other words: If we take 40 years as a reference period an increase of GDP of 1,5 per year and a shift in pensioners income from 20% to 30% of GDP would leave the non-pensioners with an income of about 60% higher than 2000, which corresponds to an annual growth rate of their income of 1,16%. *That is, of the total yearly 1,5% increase of GDP a little more than a fifth (0,34%) would be used to support the living standard of the growing part of the elderly in the population.* A higher growth rate of 2,0% would lead to an almost doubling of the non- pensioners income in spite of the shift in the distribution in favour of the elderly.

Where is the problem?

The problem is of course the management of a growth rate

Third proposition:

To maintain growth economic policies are needed which influence the supply side and the demand side of the economy.

I start from a fundamental equation which says that economic activity (Y) depends of the number of working people (E), the individual working time (WT) and the productivity (P) of the people (measured in output per hour worked).

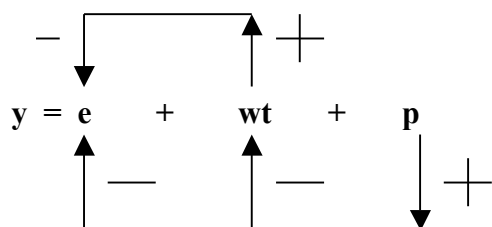
$Y = E \times WT \times P$ or in growth rates

$$y = e + wt + p$$

From this equation things seem easy. To stimulate growth one has three approaches: to increase employment or individual working hours or productivity. Of course a combination of two or all of these factors would even be better. In all cases economic growth will go up. This

is the theoretical basis for the economic policy in the EU: increase by all means the participation rate, raise working hours for every individual and promote technical progress with the aim of creating a science and knowledge based society.

In reality the recipe does not work but produces negative effects. The reason for this is that there are links and repercussions between the three determinants for economic growth. One has to remember that capitalism is not about output and material goods and services but about money and profits. In this context production is used as a means to create surplus value, which however can only be appropriated if products and services in which this surplus value is incorporated are sold on the markets. Firms will therefore only increase their production if they expect to meet sufficient demand on the markets. This is certainly not the case if people work more hours without earning correspondingly more. In that case longer work for the individual worker would mean that less workers are needed to generate a certain product and that employment would fall and growth will not happen. The increase of one element on the right hand side of the equation (wt) will not jump over to the left hand side but would be offset by a decrease of another element (e) on the right hand side..



The same is true for increases in productivity and technological progress, which from various points of view is undoubtedly desirable and useful. But it will contribute to economic growth only if it is embedded in an environment of rising domestic and external demand which realises the growth potential of higher productivity. Without such support on the demand side technological progress will only lead to a reduction of working hours or/and employment and not stimulate economic growth. So our fundamental equation is not an equation of economic growth but of the economic *growth potential*, which can only become effective if the demand side of the market is well served and employers get the opportunity not only to produce more but also to sell more.

A policy which concentrates exclusively on the improvement of supply conditions will therefore not be able to generate and maintain the economic growth necessary to ensure income security for an ageing population. Indeed it will not be able to create income security for any one in the society.

In order to make the three supply side determinants of economic growth really work growth they must be matched by demand conditions:

On the *employment* side not just any employment or increase in the participation rate at any price is necessary, even at the price of low wage and precarious jobs. Instead well paid employment with good conditions is required which gives people sufficient resources for consumption and sufficient trust in the future to spend them.

For *individual working time* an increase will not lead to positive results if it is not accompanied by higher payment. A positive way is here to transform involuntary part-time jobs at low payment into full-time positions with adequate wages or salaries.

With regard to *productivity* it will not help if increases are mostly happening on the side of the production process, leading to lower cost and less employment. The positive alternative would be to invest in product innovation and bring useful new products to the market for which consumers and users are willing to spend their money and thus to increase private demand.

To summarize the main economic arguments for the feasibility of income security for an ageing population: The necessary transfer of social wealth from the working to the retired part of the population can be managed without losses for the latter on the basis of a steady growth of the economy. The maintenance of an in this sense sustainable rate of growth requires an economic policy for full employment at high levels of wages and salaries and high public expenditure which will lead to full utilisation and further development of the growth potential of the economy.

What has all this to do with the plans to privatise public pension systems and thus to cope with the financial crisis of social security ? Strictly speaking: It has nothing to do with this.

Fourth proposition:

The privatisation of public PAYG pension systems and their substitution by capital funded schemes would not improve the prospect for income security for an ageing population. It would instead put pensions under considerable risk and change the distribution of income and wealth further in favour of the rich.

This proposition can be subdivided into three main arguments:

Firstly the macroeconomic justification for a shift from public to private systems is wrong. It is asserted that additional private savings through the transformation of contributions to PAYG systems into investment into private capital funds will enhance the growth dynamics of the economy. Therefore at the time of retirement the GDP will be higher than it would be without such capital funding and this differential would be the basis to finance the higher share of pensioners in the future GDP. For developed countries like the US or most members of the EU this is not the case for a number of reasons. *First* :it is by no means sure that the shift from public PAYG systems to private capital funded systems would lead to additional macroeconomic savings. To the extent that contributions are transferred to private savings accounts the money will be missing to pay the current pensions. These would have to be provided by the government which will have to incur huge deficits. *Further*, if the question is about additional individual savings in addition to the current contributions to the public system, the situation is also far from clear: many people will not be able to increase their savings and simply shift the existing savings from one category, say a savings account to the pension fund. If really additional saving takes place this will have an immediate deflationary effect and in the long run not improve but deteriorate the prospect for growth. *Third*, the reason for the slowdown of economic growth in the EU is not the lack of investable funds which must be healed through additional savings but the lack of sufficient final private and public demand and this lack would be exacerbated if an increasing share of income is not spent but saved. For these reasons the effect of a shift of pension systems to capital markets will in all probability not be the shift of the economy to a higher growth trajectory, but a further change of the distribution of income and wealth in favour of the higher income groups.

Secondly, the recommendation to shift public to private systems underestimates or disregards the vulnerability of the latter and the risks they imply for future pensioners. These risks, most spectacularly demonstrated by the collapses of Enron and Worldcom, have recently even been acknowledged by the OECD, which is otherwise a strong supporter of private pension funds.

They arise from the systemic instability of financial markets, which has been displayed in severe financial crisis since the beginning of the 1990s. The pension systems in Chile and in the United Kingdom – the pioneers of capital funded schemes in the world and in Europe, respectively - are in severe difficulties or even in distress and need much public money to remain afloat. Of course public schemes are not immune against economic crises. But the ups and downs of financial markets are much more accentuated than the amplitudes of regular business cycles, and therefore pension schemes which are linked to capital markets are exposed to a much higher degree of insecurity than public PAYG systems. Such risks should not be accepted in a society which commits itself to secure a decent living standard for their population after retirement.

Thirdly, private pension funds are regularly not only much riskier but also much more expensive and much less comprehensive than public schemes. For instance the latter cover also periods of unemployment and sickness which are usually excluded by private systems. The reason for the higher cost of a private system for the customer is firstly the fragmentation into hundreds of different firms with much higher outlays per customer than the uniform and comprehensive public systems. Private firms must also make profits and these are taken from the contributions of their customers. Empirical studies have shown, that private schemes use between 10% and 20% of contribution revenue for administration and profits while public systems are much cheaper and their costs never transgress 5% of their revenues.

To summarise: Contrary to widespread propaganda a (complete or partial) shift from public to private pension systems will not bring the economy on a higher path of economic growth. It will expose pensioners to higher income and welfare risks and it will make social security more expensive, less comprehensive and more insecure than the current public systems.

Fifth proposal:

While the population and particularly the pensioners will loose from a shift from the privatisation of social security, employers and particularly large financial institutions are the winners of pension “reform”.

In all countries where contributions to public systems are jointly borne by employers and employees while private schemes are financed exclusively by employees (this is for instance the

case in Germany and in France) employers will benefit from even a partial shift from one to the other system. For them a ceiling is set for contributions, and they will be exempted from any rise of contributions to private systems, which is set-up to finance the transfer from the working population to the growing elderly population. This arrangement has for instance been introduced in Germany: a ceiling has been set for the contribution to pension systems at 22% of labour wages and salaries, of which 11% are financed by employers and 11% by employees. At the same time it was announced that these 22% would not be sufficient to maintain the current relative living standard for pensioners in the year 2040 and in order to secure this living standards employees had to spend another 4% of their income for private capital funded insurance. Thus the contribution for employers was limited at 11% and that of employees raised to 15%, instead of raising both to 13%, which according to the German Ministry of Labor and Social Affairs would have been sufficient to solve the “pension crisis” in Germany. The whole story of pension reform was not about securing pensions but about redistribution of contributions and therefore net income in favour of the capital side.

Apart from this re-distributional effect, which applies only to countries with special arrangements of their historical pension systems, in all countries financial institutions – in the first place big institutional investors like insurance companies, investment and pension funds - will be the main beneficiaries of a pension reform along the envisaged lines. They receive the money that in a PAYG system would be directly transferred from the working population (contributions) to the pensioners (pensions) as raw material for their activities on the national and international financial markets, and the more contributions they accumulate the stronger is their market position. So pension reform is in reality a policy to support financial markets and specially the big actors on these markets. This contributes further to the financialisation of the economy which has not brought additional stability but instability to the economy. It has also pushed and accelerated the polarisation of income and wealth which we have observed in all countries during the last decades.

Sixth proposal:

While there is no need to privatise public security systems – and indeed all arguments speak against such a move which would only increase inequality – there is in many countries a need to improve and reform the existing public pension scheme.

This need relates to the financing of the system and particularly to the tight link between labour income, contribution to social security systems and the pension which is paid to the elderly. In view of the increasingly patchy work careers, changing lifestyles, and increasing number and periods of precarious jobs and very low wages two changes seem useful and should be considered:

First, the financial basis of the system should be broadened through the inclusion of all kinds of income – not only wages and salaries – into the obligation to contribute to the social security system. It is the social context as a whole which is the basis for the possibility to earn profits, dividends, interest and other incomes, and therefore it is only fair if these incomes contribute to the stability and social cohesion of the society. Such *broadening of the basis* would also make it possible to *reduce the rate* of contributions, which would be an equivalent to a redistribution in favour of those whose incomes are exclusively wages and salaries.

Second, to avoid poverty amongst pensioners as a result of low wages and patchwork-like professional careers with periods of unemployment, times-out for child-care and sabbaticals a minimum pension for all citizens should be set up which is well above the poverty line and should enable all citizens regardless of their previous income and career a decent living in the last phase of their lives.

Conclusion

We have in the first part of this paper discussed the economic potential and preconditions to guaranty income security in an ageing society. The necessary redistribution of income in favour of the retired generation can be achieved together with rising incomes and living standards for the working population if economic growth is sufficiently high. Because of demand restrictions such growth can in a mature economy not be expected from the working of market mechanisms alone. Strong trade unions are needed to secure a high level of wages as the main basis for private consumption, which is the by far largest part of demand in the economy. In addition economic policy has to step in and maintain a stable level of demand. In the second part of the paper it was pointed out that the current stampede towards privatisation of social security will not solve the alleged pension crisis but lead to greater insecurity, higher costs and lower pensions for the elder generation. It is a policy which is good for financial institutions but bad for the pensioners. Reforms, were needed should remain within the framework of public PAYG systems.